BRIEF IN SUPPORT OF PETITION FOR CERTIORARI.

I.

The Opinions of the Courts Below.

The opinion of the Circuit Court of Appeals for the Second Circuit was rendered on July 20, 1940. It is reported in 113 F. (2d) 664, and is to be found on pages 94 to 98 of the record herein.

The opinion of the Board of Tax Appeals is reported in 40 B. T. A. 516, and appears on pages 21 to 28 of the record herein.

II.

Jurisdiction.

1. The statutory provision believed to sustain jurisdiction is Section 240 of the Judicial Code as amended by the Act of February 13, 1925 (c. 229, sec. 1; 43 Stat. 938).

2. The judgments sought to be reviewed were entered on August 5, 1940 (R. 98, 99).

3. The proceedings in which review is sought were initiated in the United States Board of Tax Appeals and were consolidated for hearing before the Board and for argument in the Circuit Court of Appeals. They involve the liability of the petitioners for income taxes under section 167(a)(2) of the Revenue Acts of 1932 and 1934 on income of a trust created by them. Deficiency orders were entered and petitions for review duly filed in the Circuit Court of Appeals for the Second Circuit which affirmed the determination of the United States Board of Tax Appeals.

4. Cases believed to sustain jurisdiction are:
Helvering v. *Leonard,* 310 U. S. 80;
Anderson v. *Helvering,* 310 U. S. 404.

III.

Statement of the Case.

A full statement of the case has been given under heading "A" in the petition and in the interest of brevity is not repeated.

IV.

Specification of Errors.

The Circuit Court of Appeals for the Second Circuit erred in the following respects:

1. In holding that Carl M. Loeb, the trustee under the deed of trust involved in these proceedings, had no interest in the disposition of the income of said trust substantially adverse to that of the petitioners.

2. In determining that the petitioners were taxable upon the income of said trust notwithstanding that the distribution of such income was not subject to their control and that no part of such income was distributed to them nor accumulated for nor applied nor applicable to the discharge of their obligations.

3. In failing to determine that section 167(a)(2) of the Revenue Acts of 1932 and 1934 is unconstitutional if construed to require the taxing as petitioners' income of income of said trust, the distribution of which was not subject to their control and no part of which was distributed to nor accumulated for them nor applied nor applicable to the discharge of their obligations.

4. In failing to reverse the deficiency orders of the Board of Tax Appeals.

V.

ARGUMENT.

Point I.

Carl M. Loeb, the trustee, was possessed of a substantial adverse interest in the disposition of the trust income in question.

The principal question presented is whether Carl M. Loeb, the petitioners' father, had an interest substantially adverse to the petitioners in the disposition of the trust income.

Section 167 of the Revenue Acts of 1932 and 1934 provides:

> "(a) Where any part of the income of a trust
>
> (2) may, in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income, be distributed to the grantor;
>
> then such part of the income of the trust shall be included in computing the net income of the grantor."

It is the petitioners' contention that their father, Carl M. Loeb, possessed a substantial adverse interest within the intendment of the statute. This interest, it is asserted, was dual in nature. On the one hand, it was found in his untrammeled power to use the trust income to discharge his legal obligation to support his wife, and, on the other, it was explicit in the intention of the petitioners in creating the trust.

Congress has not defined the term "substantial adverse interest" as used in the statute. The Congressional purpose, however, was to block a possible means of tax avoidance by the device of vesting the power to distribute the income in some person having no stake in the trust or a

stake so insubstantial that the holder of the power would not improbably be amenable to the grantors' wishes (*Fulham* v. *Commissioner*, 110 F. (2d) 916).

The statute is aimed at immorality. A situation truly condemned and sought to be reached by it can only arise where the grantor, ostensibly relinquishing the right to income, chooses someone as trustee who will acquiesce in his wishes to the end that he may, in fact, receive or retain that which apparently he is giving away. The statute is not aimed at a trust created for a legitimate purpose obviously having no tax objective.

Whether a trust falls within the scope of the statute must be determined upon an appraisal of the trust instrument against a background of realities (*Fulham* v. *Commissioner*, *supra*); in the light of the settlors' intention in creating the trust and the course of conduct subsequent to its creation (*Commissioner* v. *Morton*, 108 F. (2d) 1005; *Henry A. B. Dunning*, 36 B. T. A. 1222; *Raoul H. Fleischmann* v. *Commissioner*, 40 B. T. A. 672).

Characterization, as indulged in by the court below, of an interest as not sufficiently "direct" avoids a decision of the question involved. For the issue is not whether one having the power to control the distribution of income is directly or beneficially interested in that income, but, rather, whether circumstances exist which would impel him, because of self-interest, to act in a manner detrimental to the interest of the settlor. Stated otherwise, the only question to be answered in a case arising under the section here involved, is whether a grantor has retained the controlling hand over the income which he appears to have given away.

The trustee here, the father of the settlors, was given the unrestricted right to distribute the trust income either to his wife, to whom he owed the legal obligation of support, or to any or all of his children. The record shows that in one taxable year under review there was no distribution

because there was no net income, and in the other year he distributed approximately $25,000 to his wife (sufficient for maintenance of the household and for personal expenses), $20,000 to a married daughter, and $5,000 to one of the settlors. To the other settlor he distributed nothing. The record also shows that the very purpose underlying the creation of the trust was to endow the father with an unrestricted right to distribute the income to his wife and to such of his children as, in the exercise of his sole and uncontrolled judgment, he should deem proper.

To suggest that the settlors, who had only recently attained their majority, one of who was "on allowance", who had created the trust at the dictation of their father and given him unrestricted control over the corpus and income, either did or could expect their father to be amenable to their desires, is indeed to close the mind to the realities. To retain such a notion in the light of what the father actually did with the income of the trust, is to replace fact with fancy. To deny that the father had an interest adverse to the grantors and that it was substantial, is to deny obvious facts.

That the trustee, vested with the power to distribute income to his wife, would be likely to exercise that right, was recognized by the Circuit Court. It viewed the petitioners' argument that this right was adverse to the interest of the grantors as having some "persuasive force", but concluded that such an adverse right was not sufficiently direct to bring it within the contemplation of the statute. The reasoning by which it arrived at this conclusion is not persuasive. A substantial adverse interest, said the court, is an interest sufficiently direct and adverse to rebut the presumption that the grantors can control, in fact, the exercise of discretion vested in another, but proof that the grantors would actually have no control over his exercise of discretion is not decisive unless it can be shown that such

a person has a substantial adverse interest. This, of course, is an endless chain of reasoning which leads nowhere.

The conclusion of the court that a substantial adverse interest must be a direct interest, is in conflict with the decisions of sister courts and of the Board of Tax Appeals.

The question was considered in *Savage* v. *Commissioner*, 82 F. (2d) 92, arising under the 1928 Act, which taxed to a grantor the income of a trust where the grantor alone, or in conjunction with any person not a beneficiary, had the right to revest in himself title to any part of the corpus of the trust. The wife had created a trust under which the income therefrom was payable to her husband for the support, maintenance and education of their children, and reserved the right of revocation, but only with the consent of her husband. The Commissioner taxed the trust income to the wife and the Board sustained his determination on the ground that the trust was not created for the benefit of the husband, that he had neither a vested nor contingent interest in the trust property or income and, hence, that he was not a beneficiary.

The Court of Appeals for the Third Circuit, however, reversed the Board and held that the husband was a beneficiary of the trust in that it made possible the maintenance of a home for him and his children, for which, under the law, he was responsible, and, hence, substantially benefited him.

In *Helvering* v. *Hormel* (111 F. (2d) 1, cert. granted Oct. 14, 1940), the Circuit Court of Appeals for the Eighth Circuit held that a wife to whom trust income was paid as guardian of her minor children for their use and benefit, had a substantial adverse interest to that of her husband in the income of the trust. Her interest, of course, was not a direct one, but because of her duty to her children it was held to be substantial and adverse to that of the settlor within the intendment of the statute. Similar determina-

tions are found in *Raoul H. Fleischmann* v. *Commissioner*, 40 B. T. A. 672, in which the Commissioner has announced his acquiescence; *Freda R. Caspersen* v. *Commissioner*, 40 B. T. A. 759, and *Olive H. Prouty* v. *Commissioner*, 41 B. T. A. 277.

Our research has uncovered no decision, either of court or Board, holding, as does the court below, that a substantial adverse interest in either principal or income of a trust must be a direct interest therein. The rule enunciated in this case is supported neither by authority nor by reason, and in the interest of taxpayer and government alike, the confusion should promptly be resolved.

POINT II.

Section 167(a)(2) of the Revenue Acts of 1932 and 1934 is unconstitutional if it be construed to require taxation to the grantor of trust income which is neither distributed to nor accumulated for him nor applied nor applicable to the discharge of his obligations, and the distribution of which is not subject to his control.

Congress has the power to adopt means fairly and reasonably calculated to prevent the avoidance of taxation. Nevertheless, the provisions of the statute adopted may be so arbitrary and capricious as to amount to confiscation and thereby offend the Fifth Amendment to the Constitution (*Heiner* v. *Donnan*, 285 U. S. 312). There are limits to the power of Congress to create a fictitious status under the guise of supposed necessity (*Helvering* v. *City Bank Farmers Trust Co.*, 296 U. S. 85).

The decision of the Supreme Court in *Hoeper* v. *Tax Commission*, 284 U. S. 206, holding a statute unconstitutional which attempted to levy a tax on a husband, based upon the combined income of both husband and wife, points to the unconstitutionality of Section 167(a)(2) if construed

to compel taxation to the petitioners of income of the trust actually distributed to others. To the same effect are *Schlesinger* v. *Wisconsin*, 270 U. S. 230, and *Bowers* v. *Kerbaugh-Empire Co.*, 271 U. S. 170, and the dissenting opinion in *Charles H. Mott* v. *Commissioner*, 30 B. T. A. 1040.

Conclusion.

It is respectfully submitted that these cases call for the exercise by this Court of its supervisory powers in order that the construction and constitutionality of the Federal statutes involved be definitely determined and the errors of the Circuit Court of Appeals for the Second Circuit be corrected, and that, to such end, writs of certiorari should be granted and the court should review the decisions of the Circuit Court of Appeals for the Second Circuit and finally reverse it.

Dated, October, 1940.

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